Appendix 7. Treatment of Arrears in the Gross External Debt Position

Introduction

1. In the 2003 *Guide*, the nonpayment, when due, of principal and/or interest resulted in a reduction in the amount outstanding of the appropriate instrument, such as a loan, and an increase in arrears (a short-term liability that was included under *other debt liabilities*), leaving the external debt position unchanged (see 2003 *Guide*, paragraph 2.29).[1] In the gross external debt position, the debt was extinguished and a new short-term debt liability was created. In line with *BPM6*, the treatment has changed; when arrears related to the late payment of principal and interest on debt instruments occur, no transactions should be imputed, but the arrears should continue to be shown in the same instrument until the liability is extinguished. Then, arrears are identified as a supplementary category of the original asset or liability, rather than treated as the repayment of the original liability and the creation of a new short-term liability.

2. This appendix summarizes the treatment of arrears in the gross external debt position, the way they are classified and presented, and identifies main changes introduced in the *Guide*. In summary (see discussion below), the treatment of arrears in the *Guide* is fully consistent with *BPM6*, and because data on arrears are important in their own right, the *Guide* recommends that detailed data on arrears (similar to that required by the 2003 *Guide*) continue to be presented, if significant.

3. Arrears are defined as amounts that are past due-for-payment and unpaid. Only the amounts past due are classified as arrears. A liability ceases to be in arrears if all overdue payments are met. Arrears can arise both through the late payment of principal and interest on debt instruments (which are recorded in the original debt instrument) as well as through late payments for nondebt instruments and other transactions (which are recorded in a new debt instrument).

Arrears on debt instruments

4. Debt service payments may be missed for a variety of reasons beyond simply the inability or unwillingness of the debtor to meet its payment obligations. A failure by a debtor economy to honor its debt obligations (default, unilateral moratorium, etc.) is not debt reorganization because it does not involve an arrangement between the creditor and the debtor (see Chapter 8). Such failure gives rise to arrears.

5. Different types of arrears are identified below. If the amounts of these different types of arrears are significant, it is encouraged that these amounts be separately identified and disseminated by the compiling economy.

- Arrears resulting from inability or unwillingness of the debtor to pay (the most common or frequent type)
- Sometimes arrears arise not from the ability of the original debtor to provide national currency but from the inability of the monetary authorities to provide foreign exchange to another resident entity, so preventing that entity from servicing its foreign currency debt. These so-called *transfer arrears* remain those of the original debtor sector
- Another circumstance may be when the creditor has agreed in principle to reschedule debt, i.e., reorganize payments that are falling due—but the agreement has yet to be signed and implemented. In the meantime, payments due under the existing agreement are not made, and arrears arise—so-called *technical arrears*. Such arrears might typically arise in the context of Paris Club

[1] This treatment of arrears was fully consistent with *BPM5* (see *BPM5*, paragraph 458).

agreements between the time of the Paris Club rescheduling session and the time when the bilateral agreements are signed and implemented. If the agreement in principle lapses before the agreement is signed, then any accumulated arrears are no longer technical arrears

- *Involuntary arrears* resulting from developments in the creditor country that prevents the debtor from making payments (e.g., in cases of war or international economic sanctions against the creditor country)[2]
- *Validation arrears* resulting from disagreement between the creditor and the debtor on the amounts due
- *Litigation arrears* resulting from major disputes about the legitimacy of debt liabilities.

6. For arrears arising from a debt contract, interest should accrue at the same interest rate as on the original debt, unless a different interest rate for arrears was stipulated in the original debt contract, in which case this stipulated interest rate should be used. The stipulated rate may include a penalty rate in addition to the interest rate on the original debt. Typically, the first type of arrears and transfer types of arrears can involve penalties, while technical and involuntary arrears may not; penalty rates in validation and litigation arrears would be treated on a case-by-case basis.

7. According to the accrual basis, repayments of debts (both periodic payments and amount to be paid at maturity) are recorded when they are extinguished (such as when they are paid, rescheduled, or forgiven by the creditor). When arrears related to the late payment of principal and interest on debt instruments occur, no transactions should be imputed. If interest is not paid when due, the gross debt position will increase by the amount of interest that has accrued during the period and is in arrears at the end of the period. However, if the contract provided for a change in the characteristics of a financial instrument when it goes into arrears, this change should be recorded as a reclassification in the gross external debt position.[3]

8. While a debt instrument that includes arrears might be valued at both nominal and market value, if relevant (this *Guide* recommends that both market and nominal values be provided for debt securities—see paragraph 2.33), when arrears are separately presented (such as in Table 4.2) and/or identified as memorandum to tables, they should be valued at nominal value.[4] This is because it is a measure of the overdue amount that the debtor owes to the creditor, according to the terms of the contract between the two parties.

9. Incurring arrears does not involve a transaction, because it is a unilateral act of one party. Therefore, it is not shown as giving rise to entries in the standard presentation of the financial account of the balance of payments. Nevertheless, arrears related to exceptional financing are recorded as transactions in the analytical presentation of the balance of payments.[5]

Arrears on nondebt instruments and other transactions

10. Arrears can also arise through late payments for nondebt instruments and other transactions. For instance, a financial derivative contract is not a debt instrument (see Chapter 3) but if it comes to maturity and a payment is required but not made, arrears are created.

11. Consistent with the accrual principle, an overdue obligation to settle a financial derivative contract is not recorded as a transaction in the balance of payments; however, the obligation is reclassified to a debt liability because of the change in the nature of the claim (see *BPM6*, paragraphs 3.56 and *2008 SNA*, paragraph 3.175). Once a financial derivative reaches its settlement date, any unpaid overdue amount is classified as *other debt liabilities* in the gross external debt position (in the IIP is reclassified as *other*

[2] Involuntary arrears may also include cases whereby payments are not made because the creditor does not bill the debtor in a timely manner.

[3] This reclassification is recorded in the international accounts in the other changes in the financial assets and liabilities account.

[4] If arrears are traded on secondary markets, as sometimes occurs, then a separate market value could be established.

[5] This treatment is because, although the accumulation of arrears is not a transaction, it is an action the authorities may take to manage their payments requirements (the analytical presentation of the balance of payment is focused on the actions of the authorities to meet balance of payments needs, and accumulating arrears is an action the authorities can take for this purpose). Exceptional financing and recording of arrears within exceptional financing are discussed in Appendix 1 of *BPM6*.

accounts payable-other), as its value is fixed, and thus the nature of the claim becomes debt (see *BPM6*, paragraph 5.82).

12. Similarly, arrears related to late payments of taxes, purchase and sale of securities, securities lending fees, gold loan fees, wages and salaries, dividends, and social contributions are classified as *other debt liabilities* in the gross external debt position (*other accounts payable—other* in the IIP; see paragraph 3.42 and *BPM6*, paragraph 5.73).

13. Also, if goods and/or services are supplied and not paid for on the contract payment date or a payment for goods and/or services is made but the goods and/or services are not delivered on time, then arrears are created. These new debt liabilities for late payments or late delivery of goods and/or services should be also recorded as *trade credit and advances* in the gross external debt position (see paragraph 3.43) as well as in the IIP. These arrears are typically nonnegotiable instruments and their primary valuation is nominal value.

14. If an item is purchased on credit and the debtor fails to pay within the period stated at the time the purchase was made, any extra charges incurred should be regarded as interest and accrue until the debt is extinguished (see *BPM6*, paragraph 11.71).

Presentation of Data on Arrears

15. In macroeconomic statistics, arrears should continue to be shown in the same instrument[6] until the liability is extinguished, and they are not separately identified as a debt instrument. Information on arrears is useful for various kinds of policy analyses and solvency assessments and should supplement the debt statistics where significant. Compilers will need to collect and disseminate information on debt-service payments in arrears because this information is no longer presented separately in an accrual basis of recording system. Information on arrears should continue to be collected from their creation, i.e., when payments are not made, until they are extinguished, such as when they are repaid, rescheduled, or forgiven by the creditor.

16. The *Guide* recommends that total value of arrears by sector be separately identified in memorandum to Table 4.1 (arrears are recorded until the liability is extinguished and are presented in nominal value in the memorandum). Such information is of particular analytical interest to those involved in external debt analysis, since the existence of arrears indicates the extent to which an economy has been unable to meet its external obligations. This information on arrears is essentially the same as that in the body of Table 4.1 of the 2003 *Guide*. Similarly, total value of arrears by sector is separately identified in memorandum to Table 5.1 that presents the gross external debt position on the basis of a public-sector-based approach.

17. The 2003 *Guide* encouraged a further disaggregation of arrears into arrears of principal and of interest in the gross external debt position table, for economies in which arrears are very significant (see 2003 *Guide*, paragraph 4.5). The *Guide* introduces a new memorandum table, Table 4.2, which presents arrears at nominal value by sector and disaggregated into arrears of principal and interest.

18. The value of arrears is also separately identified in memorandum to Tables 4.3 (Gross External Debt Position: Short-Term Remaining Maturity—Total Economy) and 7.1 (Gross External Debt Position: Short-Term Remaining Maturity—By Sector).

19. The treatment of arrears in the *Guide* is fully consistent with *BPM6*. In both, the gross external debt position and the IIP, arrears on debt instruments are recorded under the appropriate debt instrument, while arrears on nondebt instruments and other transactions are recorded as new debt liabilities within the appropriate instrument, i.e., either *trade credit and advances* or *other debt liabilities* in the gross external debt position—see paragraphs 11–13 above—and either *trade credit and advances* or *other accounts payable-other in* the IIP.

[6] As mentioned above, a new debt instrument is created when arrears arise through late payments for nondebt instruments and other transactions.

Box A7.1 Arrears by Sector

The *Guide* introduces a new memorandum table, Table 4.2, which presents arrears at nominal value by sector disaggregated into arrears of principal and interest. The first level of disaggregation is by institutional sector. The primary disaggregation is by the four sectors of the compiling economy described in Chapter 3—*general government, central bank, deposit-taking corporations, except the central bank, and other sectors*. A disaggregation of the other sectors into *other financial corporations, nonfinancial corporations, and households and nonprofit institutions serving households* is provided. Intercompany lending between entities in a direct investment relationship is separately presented. The second level of disaggregation is by principal and interest (interest includes accrued interest on arrears of principal and interest).

Table 4.2 Gross External Debt Position: Arrears by Sector[1,2]

	End Period
General Government	
Principal	
Interest	
Central Bank	
Principal	
Interest	
Deposit-Taking Corporations, except the Central Bank	
Principal	
Interest	
Other Sectors	
Principal	
Interest	
Other financial corporations	
Principal	
Interest	
Nonfinancial corporations	
Principal	
Interest	
Households and nonprofit institutions serving households (NPISHs)	
Principal	
Interest	
Direct Investment: Intercompany Lending	
Principal	
Interest	
Debt liabilities of direct investment enterprises to direct investors	
Principal	
Interest	
Debt liabilities of direct investors to direct investment enterprises	
Principal	
Interest	
Debt liabilities between fellow enterprises	
Principal	
Interest	
Total Economy	

[1] Valued at nominal value.
[2] Interest includes accrued interest on arrears of principal and interest.